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COORDINATED ISSUE
PETROLEUM INDUSTRY
NORTH SEA IDC TRANSITION RULE

ISSUES

1. What is the meaning of "minority interest" as used in the North Sea IDC Transition rule?

2. When is a minority interest in a license for development acquired for purposes of the North Sea IDC transition rule?

3. Does the transition rule override the amendments to section 291(b) of the Internal Revenue Code made by the TRA, so that the change from mandatory capitalization of 20% of intangible drilling costs ("IDC") over 36 months to capitalization of 30% of IDC over 60 months would not apply to foreign IDC described in the transition rule?

FACTUAL PATTERN

Several petroleum companies have acquired interests in production licenses covering blocks located in the U.K. and The Netherlands sectors of the North Sea. Many of these licenses were acquired prior to December 31, 1985, with consent to development proposals obtained after December 31, 1985. These taxpayers are relying on a transition rule provided by section 411(c)(2) of the Tax Reform Act of 1986 (1986 Act) to treat intangible drilling costs (IDC) under the more liberal rules in effect prior to amendments made to sections 263 and 291 of the Internal Revenue Code (the Code).

The U.K. issues seaward petroleum production licenses to "search and bore for and get petroleum" in the North Sea. Those licenses have a mixed character: they are in the form of a commercial contract, yet incorporate mandatory, model clauses required by law. Daintith and Willoughby, U.K. Oil and Gas Law**,** paragraph 1–220 (2d ed. 1984) ("Daintith"). They provide administrative and contractual rights, and are best construed as conferring an exclusive license to search for petroleum, together with a grant of all the petroleum extracted under the license.

The U.K. issues a single production license for a North Sea block. That license sets out the rights and obligations between the joint licensees and the U.K, such as, royalty payments, approval of the operator, and periodic reports. It does not address the position of the joint licensees relative to each other. That matter, together with the rules regulating the operation of the joint venture, are set out in a joint operating agreement (JOA) that is generally negotiated after the production license has been awarded to the joint licensees.

Under the license, the U.K. controls all development and production. A licensee must submit its production program for U.K. approval prior to carrying out any development or production of petroleum. The U.K. may also control petroleum production at any time after the initial approval of the production program. Breach of the approval provisions is generally grounds for revocation of the license.

Current U.K. practice requires that development and production proceed under a three–stage approval process. The first stage grants approval for the exploration phase. The second stage grants approval for the major production period. The third stage grants approval for the remainder of production.

The Netherlands, by virtue of its sovereign rights over the continental shelf, is the owner of all its natural resources. Ownership of those resources may be transferred to the holder of the exploitation license at the moment the oil reaches the wellhead. The exploration of oil and gas on the Continental Shelf, outside the territorial waters, is governed by the Continental Shelf Act of 1965, the Regulations of February 6, 1967, and the General Administrative Order of January 31, 1966. Generally, the Act provides that no exploration or production is allowed unless a license is obtained from the Government. The offshore system provides for exploration and production licenses. An offshore exploration license has a duration of 10 years, but after six years the Licensee must relinquish approximately half of the area. Exploratory work must commence within eight months of the grant of the license. An exploration license holder who discovers an economically producible quantity of petroleum is entitled to a production license. An application for a production concession can be made only after it has been demonstrated that hydrocarbons in exploitable quantities are present. At the time a production license is granted, the Government sets forth the conditions under which the production can be carried out. Production licenses have a maximum duration of 40 years.

Licensees and contractors responsible for the daily execution of the licensed activities are required at the very least to have a permanent establishment in The Netherlands and such permanent establishments are subject to Dutch tax on their North Sea income. In most instances they would be required to form a Dutch company with state participation instead of only a branch operation.

Discussion

Section 263(c) of the Code exempts intangible drilling and development costs from the capitalization requirements of section 263(a)(1) and permits such costs to be expensed.

Section 263(i) of the Code, as amended by the 1986 Act, provides that in the case of intangible drilling and development costs paid or incurred with respect to an oil, gas, or geothermal well located outside of the United States, 263(c) shall not apply, and such costs shall, (1) at the election of the taxpayer be included in adjusted basis for purposes of computing the amount of any deduction allowable under section 611 or, (2) be allowed as a deduction ratably over the 10 year taxable period beginning with the taxable year in which such costs were paid or incurred.

Section 291(b) of the Code provides special rules for the treatment of intangible drilling costs incurred by an integrated oil company. Prior to the 1986 Act, section 291(b) required 20 percent of IDC expenses to be capitalized and amortized over 36 months. The Act modified section 291(b) to increase the capitalized percentage to 30 percent and to increase the amortization period to 60 months.

Section 411(c) of the 1986 Act added a transition rule that provides:

> The amendments made by this section shall not apply with respect to intangible drilling and development costs incurred by United States companies pursuant to a minority interest in a license for Netherlands or United Kingdom North Sea development if such interest was acquired on or before December 31, 1985.

Thus, IDC must meet four criteria to fall under the transition rule. It must have been incurred (i) by a United States company, (ii) pursuant to a minority interest, (iii) in a license for Netherlands or U.K. North Sea development, (iv) where the minority interest was acquired on or before December 31, 1985.

Issue 1

The transition rule requires that the U.S. company hold a minority interest in the license for development.

Although the transition rule does not define "minority," income tax regulations promulgated for other purposes have defined that term to mean an interest of less than 50%. See section 1.332-5 of the Income Tax Regulations ("Distributions in liquidation as affecting minority interests") and 1.337–5 of the regulations ("Special rules for certain minority shareholders"). There is no suggestion that Congress intended to have a different meaning than this usual one.

Issue 2

The term "license for development" used in the transition rule refers to a specific governmental authorization to begin development. Accordingly, to be eligible for transition rule relief, a taxpayer must have obtained a specific developmental authorization from the governmental agency which has jurisdiction over the North Sea area. This authorization must logically be obtained on or before the December 31, 1985, cutoff date, since the statute requires that taxpayer have an interest in such a license before that date.

Taxpayers have asserted that they obtained interests in licenses for development on or before December 31, 1985, despite the fact that the U.K. Government and the Dutch Government do not issue "licenses for development" -- they only issue licenses for exploration and production. Development is permitted under a production license if certain additional requirements are met. For purposes of the U.K., one of these requirements is the submission of a development plan and the approval of such plan by the U.K. Government. The approval of the development plan must have been obtained on or before the cut off date. The Dutch government requires that an application for a production concession can be made only after it has been demonstrated that hydrocarbons in exploitable quantities are present.

The controversy concerning a timely "license" centers around determining whether and at what point a "license" as contemplated by the transition rule should be considered the equivalent of an operating interest. The transition rule failed to incorporate any U.K. or Dutch law or practice into its specific wording. It is therefore useful to be guided by comparison to the U.S. Government’s licensing regime for offshore areas in the outer continental shelf (OCS). Under this regime, "a license for development" is not the equivalent of an "operating interest."

The transition rule applies to IDC expenses under Section 263(c) and Regulation 1.612-4. Regulation 1.612-4(a) generally provides that IDC may be deducted by an operator who holds a working or operating interest in any tract of land either as a fee owner or under a lease or any other form of contract granting working or operating rights. The existence of a working or operating interest implies the existence of an interest burdened by the costs of development. The term "license" has been defined as an authorization that grants permission or authority to carry out an activity (See Federal Land Bank of Wichita v. Kiowa County, 368 U.S. 146, 154 n.23 (1961)). A grant of an operating interest may be viewed as a form of contract permitting the election to deduct IDC under section 1.612-4(a). However, the license referred to by the transition rule is a license for development, not a license to grant an operating interest (e.g. a leasehold). The transition rule looks to who has permission to develop the lease, not to who is required to pay the development costs. While a license interest holder would not be eligible to deduct IDC if no operating interest existed, because an operating interest is required to deduct IDC under all circumstances, possession of such an interest is not sufficient to qualify under the transition rule.

A distinction exists in U.S. law between a lease and a license for development. This distinction is made in both the Outer Continental Shelf Lands Act (OCSLA), as amended, 43 U.S.C.A. 1331 (1986) and in the Coastal Zone Management Act, 16 U.S.C. 1453 (13) (1985). Under OCSLA, a multiple step regime is imposed consisting of four distinct stages of development of an offshore oil well as follows: (1) formulation of a five year leasing plan by the Department of the Interior; (2) lease sales; (3) exploration of the lease; and (4) development and production. Under stage (2), a lessee must submit preliminary exploration, development and production plans for approval. If those plans are not approved, no further activity in the nature of development or production is permitted. Under stages (3) and (4), the lessee must submit for approval <u>separate</u> <u>plans</u> for exploration and for development and production. <u>See</u> <u>Secretary of the Interior v. California</u>, 464 U.S. 310 (1984). A significant pair of quotations emerges from this decision:

> "Since 1978, the sale of a lease has been...carefully separated from the issuance of a federal license or permit to explore for, develop or produce gas or oil on the OCS." [464 U.S. at 336 (1984)].
>
> "[T]he purchase of an OCS lease, standing alone, entails no right to explore for, develop, or produce oil and gas resources on the OCS." [464 U.S. 340 (1984)].

<u>See</u> <u>also</u> <u>Village of False Pass v. Clark</u>, 733 F.2d 605, 608-09 (9th Cir. 1984).

The Supreme Court has concluded that although the distinction between a lease and a license may seem "exceedingly fine", it was a distinction that Congress had codified "with great care". 464 U.S. at 335-336 (1984).

Given the established distinction between a lease and license in U.S. law, it is reasonable to conclude that Congress had that distinction in mind in adopting the transition rule, particularly as there is a similar staged development regime in the U.K. and the Netherlands.

Issue 3

Section 411 of the TRA is entitled "Treatment of Intangible Drilling Costs and Mineral Exploration and Development Costs." Subsection 411(a) amends section 291(b) of the Code by changing the required capitalization of foreign IDC from 20% of the IDC over 36 months to 30% of the IDC over 60 months. Subsection 411(b) adds section 263(i) that restricts the use of foreign IDC. Subsection 411(c) supplies the transition rule discussed above and provides that "[t]he amendments made by this section" do not apply to United States companies meeting the rule.

Because the transition rule refers nonexclusively to all the amendments made "by this section," that rule applies to all the IDC amendments made in section 411. Accordingly, when a United States company meets the tests of the transition rule, it is excluded from the changes made by subsections 411(a) and (b) and may continue to capitalize 20% of its eligible foreign IDC over 36 months.

CONCLUSIONS

1. The term "minority interest" used in the transition rule refers to an interest that is less than 50% of the tenancy in common interests in the license for development.

2. The transition rule requires that a United States company acquire a minority interest in a North Sea development license on or before December 31, 1985. As discussed above, a minority interest in a North Sea development "license," is established when specific authority to develop the offshore production license is obtained from the appropriate governmental agency.

3. The transition rule overrides the amendments to I.R.C. 291(b) made by the TRA. A company meeting the transition rule may continue to capitalize 20% of its foreign IDC over 36 months.